Before the
FEDERAL COMMUNICATIONS COMMISSION FCC 94-286
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	
Protection and Competition	)	MM Docket No. 92-266
Act of 1992: Rate Regulation	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	
Protection and Competition	)	MM Docket No. 93-215
Act of 1992: Rate Regulation	)	

SIXTH ORDER ON RECONSIDERATION, FIFTH REPORT AND ORDER, AND SEVENTH NOTICE OF PROPOSED RULEMAKING

Adopted: November 10, 1994 ; Released: November 18, 1994

By the Commission: Commissioner Quello issuing a statement; Commissioner Barrett dissenting and issuing a statement; Commissioner Ness issuing a statement; Commissioner Chong dissenting in part and issuing a statement.

Comment Date: January 13, 1995
Reply Comment Date: February 13, 1995

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I. Introduction[1*]

1. In 1992, Congress passed the Cable Television Consumer Protection and Competition Act[1] ("1992 Cable Act") in large part to ensure that where competition for cable services is absent, cable rates will be regulated to protect the interests of consumers.[2] Since the passage of the 1992 Cable Act, the Commission has adopted and implemented comprehensive rules governing cable rates.[3] In February 1994, we adopted a further notice of proposed rulemaking to determine whether we should amend our rules to provide additional incentives for adding new programming services.[4] In this Report and Order we modify our rules in order to provide cable operators with additional incentives to expand their facilities and services in a way that both ensures that cable rates are reasonable and expands the opportunities for cable programmers to reach viewers.[2*] These incentives will: (1) allow cable operators to offer new product tiers ("NPTs") to be priced as operators elect, provided certain limited conditions are met; (2) permit cable operators to add new channels at reasonable prices to existing cable programming services tiers ("CPSTs");[3*] and (3) create an additional option pursuant to which small cable operators may add channels to CPSTs. In addition, we determine that a la carte packages are CPSTs and therefore subject to rate regulation. We also confirm that cable operators do not have to obtain the affirmative consent of subscribers before making rate adjustments so long as the changes are permitted under our rules and the fundamental nature of the affected tier is unaltered. Finally, we decide not to adopt our proposal modifying restrictions on transactions between cable operators and their affiliates; instead, we retain our existing cable affiliate transaction rule.

[1*] Substantive notes are indicated by a number with an asterisk and are placed at the bottom of the page. Notes containing only citations are indicated by separately sequenced numbers and are placed as endnotes.

[2*] In this order, we modify our rules in light of comments filed in response to our *Fifth Notice of Proposed Rulemaking* in this docket. *Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking* ("*Second Recon. Order*" or "*Fourth Report*" or "*Fifth Notice*") MM Docket 92-266, FCC 94-28, 59 FR 1743 (1994). We also reconsider, in response to the petitions for reconsideration and on our own motion, certain decisions made in the *Fourth Report and Order* in this docket. The Commission retains jurisdiction to modify on its own motion an order from which reconsideration is sought. *See* 47 U.S.C. § 405; 47 C.F.R. § 1.108; *see also Central Florida Enterprises v. FCC*, 598 F. 2d 37, 48 n.51 (D.C. Cir. 1978).

[3*] In this Report and Order, unless indicated otherwise, we use "CPSTs" to mean cable programming service tiers that are rate regulated under Section 76.922 of our rules. Although new product tiers are CPSTs within the meaning of the Communications Act of 1934, as amended by the 1992 Cable Act (the "Communications Act") § 623(l)(2), 47 U.S.C. § 543(l)(2), in this Report and Order, they are separately referred to as new product tiers or NPTs.

II. Executive Summary

2. The 1992 Cable Act seeks to address problems that arise from the market power cable operators have over the distribution of video programming in virtually all geographic markets.[4*] That market power may allow the operator to limit access for programmers and to pay less than competitive prices for programming. The cable operator's market power also may allow the operator to restrict the supply of programming to consumers and to charge higher than competitive prices for programming.[5] Thus, the Commission is concerned with the possible exercise of market power by operators in two markets: (1) the purchase of programming from programmers and (2) the sale of services to subscribers.

3. Under the 1992 Cable Act, we must reconcile and accomplish the goals of ensuring that cable rates are reasonable, while expanding opportunities for cable programmers to reach viewers.[6] These goals must be pursued with regard to current unused channel capacity and with regard to capacity that may be added by operators in the future. We are convinced that our current rules, which permit operators to increase rates to reflect costs associated with adding channels and to obtain a 7.5% mark-up on new programming costs, by themselves do not create a sufficient incentive for most operators to provide subscribers with additional channels from either unused or new capacity. The Commission recognizes that under current industry practices, new programming typically must be offered in packages or bundles if it is to obtain sufficiently high subscription rates to be commercially successful. Therefore, this new programming must be added to a cable operator's basic service tier ("BST"), to a CPST or offered in a new package. However, in developing additional incentives for adding channels to a cable operator's offerings, we are mindful that consumers are entitled to reasonable prices for basic and cable programming services, set pursuant to the 1992 Cable Act.

4. New Product Tiers. To accommodate the introduction of new packages of channels, we will permit cable operators to offer a new type of CPST called an NPT. Operators are permitted to price these NPTs as they elect. The Commission has determined that NPTs and current CPSTs will compete with each other, ensuring that the price for NPTs will not be unreasonable. As explained more fully in this Report and Order, the conditions

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[4*] *See* 1992 Cable Act § 2(a)(2). In 1990, there were fewer than 50 cases in which a second cable operator (an "overbuilder") entered a local market in direct competition with the incumbent cable operator over a significant portion of the incumbent's territory. *Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming, First Report ("Competition Report")*, CS Docket No. 94-48, FCC 94-235 (adopted Sept. 19, 1994, released Sept. 28, 1994) at para. 55. The Commission is aware of relatively few overbuilds or overbuild proposals since that time. *Id.* at para. 60. Moreover, providers of video programming using technologies other than cable, such as satellite providers, generally have not yet reached market penetration levels necessary to constitute "effective competition" with cable operators as defined under the Act. *Id.* at para. 201.

for offering NPTs are: (1) cable operators must continue to offer their current BSTs and CPSTs at prices set by regulations we established previously; (2) cable operators may not weaken the status of current tiers as reasonably priced competitive alternatives to NPTs by removing channels from existing tiers and offering them on NPTs; (3) cable operators must continue to offer BSTs and current CPSTs in such a manner that subscribers should reasonably be aware that they may choose whether or not to subscribe to the NPT; and (4) a subscriber may not be charged for an NPT unless the cable operator has obtained the subscriber's affirmative consent. In addition, operators generally may not require consumers to subscribe to a CPST as a condition for subscribing to an NPT. Further, operators may not require subscription to an NPT as a condition for subscribing to a CPST.

5. Under these rules, operators may offer the same channel simultaneously on both a CPST and an NPT. This option gives the operator greater flexibility to market NPTs so that they are more attractive to subscribers. Furthermore, operators may place new programming services[54] on existing CPSTs and, at any time, move them to an NPT. In addition, operators may add a channel to an NPT that was previously on a BST or CPST, if the channel was dropped from the BST or CPST before September 30, 1994. For channels that were offered on a BST or CPST on September 30, 1994, operators may not drop any of those channels and move them to an NPT unless they wait a minimum of two years from the time the channel was dropped.

6. In short, our rules governing NPTs ensure that subscribers may choose to obtain additional programming at reasonable rates. In addition, our rules are clear and simple. Cable operators are not required to complete any forms or obtain any regulatory approval to offer NPTs, and they may set the price for the tier at the level they elect.

7. A La Carte Package Offerings. Under the 1992 Cable Act, video programming offered on a per channel or per program (a la carte) basis is not subject to rate regulation. The Commission has determined that some cable operators have evaded rate regulation by purporting to offer channels a la carte, when in fact the individual offerings were not a realistic service offering. This determination has lead the Commission to conclude, contrary to prior decisions, that a la carte packages are CPSTs within the meaning of Section 3(l)(2) of the 1992 Cable Act. As such, the packages are subject to rate regulations. Operators are free, however, to create packages of a la carte channels under our new rules governing NPTs. A la carte packages available on April 1, 1993 remain grandfathered.

8. Rate Adjustments for Channels Added to BSTs and CPSTs. The Commission's existing rate regulation rules permit operators to increase rates by a per channel amount when channels are added to BSTs and CPSTs, with the per channel amount decreasing as the number of channels on a system increases. These rules also permit operators to pass through

[54] For purposes of this Report and Order, a cable operator's "new programming services" are programming services that were not offered on its cable system prior to October 1, 1994.

to subscribers the costs of obtaining programming plus a 7.5% mark-up on new programming costs. The comments we have received in response to the *Fifth Notice* provide evidence that these existing rules may not provide sufficient incentives for systems with more than 12 current channels to add new channels (especially new channels with low license fees) to CPSTs. Because appropriate incentives for adding new channels serves the statutory goal of "promot[ing] the availability to the public of a diversity of views and information,"[7] we conclude that the rate regulations ought to be supplemented to incorporate a flat fee mark-up for adding new channels to a CPST. The revised regulations may be used to adjust rates after December 31, 1994, for channel additions occurring after May 14, 1994.

9. Operators electing to use the new rules will be allowed to take a per channel mark-up of up to 20 cents for each channel added to CPSTs. This 20 cents per channel adjustment represents the Commission's best estimate of the average amount by which operators in a competitive environment would adjust rates for the addition of a new channel, exclusive of programming costs. Operators may make rate adjustments under this rule at any time during the three-year period beginning on January 1, 1995. They may not make per channel adjustments to monthly rates totalling more than $1.20 per subscriber over the first two years of the three-year period for new channels added on CPSTs or by more than $1.40 over the full three-year period (the "Operator's Cap"). Operators may make the 20 cents per channel adjustment in the third year only for channels added in that year. Operators electing to use the per channel adjustment in the new rules may not take the 7.5% mark-up on programming cost increases for channels added after May 14, 1994.

10. The Operator's Cap is based on our observations of cable industry behavior prior to the 1992 Cable Act, adjusted for the lack of effective competition prevalent in the industry, so as to replicate a competitive market. The Commission believes the Operator's Cap will provide an adequate incentive to operators to add new services to CPSTs, while protecting subscriber interests by keeping overall regulated rates reasonable.

11. Operators may use any portion of the Operator's Cap to recover license fees associated with adding new channels to CPSTs. In addition, operators may recover an additional amount of not more than 30 cents per subscriber per month for license fees associated with adding new channels (the "License Fee Reserve") during the first and second years the Operator's Cap is in effect. The License Fee Reserve is necessary because, without one, operators might have incentives to add no-cost or low-cost channels to CPSTs. We believe our rate regulations should not distort market incentives for cable operators to add channels that subscribers are most likely to desire, whether high-cost or low-cost, and the License Fee Reserve seeks to accomplish this goal. In the third year, license fees will not be subject to special rules, but will be subject to our general rate rules.

12. Small System Relief. Our revised rules allow independent small systems and small systems owned by small multiple system operators to pass through to subscribers the costs of new headend equipment for adding not more than seven new channels to CPSTs over the next three years. The amount the qualifying small system may recover is limited to the

actual cost of the headend equipment necessary to add a channel, not to exceed $5,000 per channel, plus the channel's licensing fee, if any. The cost of headend equipment must be amortized over the useful life of the equipment and operators will be allowed an 11.25% return on the undepreciated investment. Alternatively, small systems may use the current or revised channel addition rules that are available to all operators.

13. Negative Option Billing. We affirm that an operator's decision to add, delete or replace channels on any tier is outside the negative option billing prohibition of the 1992 Cable Act -- so that the cable operator does not have to obtain each subscriber's affirmative consent before making a change -- if the channel changes do not alter the fundamental nature of the tier. Specifically, we determine that the affirmative consent requirements of the 1992 Cable Act[8] do not apply: (1) when a cable operator raises its rates as a result of passing through external costs or inflation adjustments under the Commission's rules or (2) when a cable operator changes its rates as a result of the addition, deletion or substitution of channels pursuant to the Commission's "going forward" regulations, unless there has been a change in the fundamental nature of a tier. We determine that the addition of a relatively few channels to a tier as is permitted by our revised channel addition rules will not, except in the case of an unusually small tier, change the fundamental nature of a tier, and accordingly does not require affirmative consent. We also determine that state or local consumer protection laws that conflict with or undermine the rate regulation rules established pursuant to Section 3 of the 1992 Cable Act may not be enforced.

14. Affiliate Transactions. We decline to adopt a proposal to limit the application of a prevailing company price as a measure of a reasonable price for an affiliate transaction. The proposal would have allowed the use of prevailing company prices only for affiliate transactions in which the affiliate sells at least 75% of its output to nonaffiliates.[9] The record demonstrates that many programming services that have achieved widespread distribution among cable operators would be unable to establish a prevailing company price under the proposed rule because of their affiliations with multiple system operators. We believe it would not be in the public interest to bar such programmers from using their prevailing price because there is no basis in this record to conclude that cable operators are paying excessive amounts for assets or services from those unregulated affiliates. We will, therefore, retain our existing rule, which provides that an operator may value an asset or service at the prevailing company price if the affiliated provider has provided the same kind of asset or service to a substantial number of third parties.

15. 7.5% Markup on Increases in License Fees. We have decided not to allow operators using the per channel adjustment of up to 20 cents under our new rules to take the 7.5% mark-up on programming costs or cost increases for such channels. We also solicit comment on (1) whether operators electing to use the per channel adjustment under our new rules should be allowed to take the 7.5% mark-up on programming cost increases for channels added before May 15, 1994, and (2) whether operators electing to use the current going forward rules should be permitted to pass-through the 7.5% mark-up on new programming cost increases after the initial mark-up of programming costs of new channels.

III. New Product Tiers

A. Background

16. In developing our cable rate regulations, we are guided by the policy goals set forth by Congress in enacting the 1992 Cable Act.[10] These goals are:

(1) promote the availability to the public of a diversity of views and information through cable television and other video distribution media;
(2) rely on the marketplace, to the maximum extent feasible, to achieve that availability;
(3) ensure that cable operators, where economically justified, continue to expand their capacity and the programs offered over their systems;
(4) where cable television systems are not subject to effective competition, ensure that consumer interests are protected in the receipt of cable service; and
(5) ensure that cable television operators do not have undue market power vis-a-vis video programmers and consumers.[11]

17. The 1992 Cable Act requires us to ensure that CPST rates are not unreasonable upon the receipt of a specific complaint.[12] The Act requires the Commission to establish criteria for determining whether a rate is unreasonable after considering a number of factors, such as the rates of similar systems, the rates charged by cable operators that face competition, and the operator's costs and revenues.[13] The 1992 Cable Act also permits the Commission to consider other relevant factors for determining what constitutes unreasonable rates for CPSTs.[14]

18. In the *Report and Order and Further Notice of Proposed Rulemaking* in MM Docket No. 92-266 (*"Rate Order"*), we determined that, to comply with the statute, our standards for identifying unreasonable CPST rates must reflect a reasonable balancing of the statutory factors.[15] In considering the factors, we decided to give primary weight to the rates of systems subject to effective competition.[16] Accordingly, the benchmark formula we developed for the purpose of establishing initial rates for regulated cable services was based on a comparison of rates for cable systems in competitive markets with a random sample of systems that did not face effective competition.[17] Using econometric techniques, we established a "competitive differential" by estimating the difference between competitive and noncompetitive rates. We also designed the benchmark formula to comply with the other statutory factors for determining whether CPST rates are unreasonable.[18] In addition, the statutory factors were given consideration in the cost-of-service approach which we established as an alternative to the benchmark approach.[19]

19. We also decided that a "tier neutral" approach was preferable to establishing different rate regulation schemes for BSTs and CPSTs.[20] We adopted the same benchmark

approach for purposes of resolving complaints regarding CPST rates as for determining whether basic rates are reasonable, and we applied the benchmark in the same manner to determine the initial permitted per channel rate for a CPST.[21] For the purpose of adjudicating an initial complaint, we determined that a per channel rate for a CPST at or below the benchmark at the time the complaint is filed is reasonable and will be a permitted rate.[22] For a system with rates at the time of regulation that are above the benchmark, the permitted rate level for the system is the system's September 30, 1992 per channel rate, reduced by a competitive differential of 17%, mitigated by annual inflation increases.[23] Under our transition rules, the requirement that rates be set in accordance with this general rule does not apply immediately to (1) small operators, (2) systems whose March 31, 1994 rates are below the benchmark, or (3) systems whose March 31, 1994 rates are above the benchmark but whose permitted rates are at or below the benchmark.[24]

20. We have also sought to adopt rules that promote "a diversity of views and information" and ensure that "cable operators continue to expand . . . programs offered over their systems."[25] Under these rules, cable operators may increase rates for BSTs and CPSTs to reflect inflation, increases in external costs, and the addition of new channels.[26] The current formula for channel additions permits operators to collect a sliding per channel adjustment for adding new programming channels to CPSTs[27] and to recover all programming expenses associated with adding channels, plus a 7.5% mark-up on new programming expenses.[28]

B. Comments

21. A number of programmers have expressed the view that the cable industry's ability to create new programming networks that can benefit consumers depends on operators' being able to offer these new services in packages of programming.[29] They assert that if new services must be offered on a stand-alone basis, the costs of marketing will increase the retail costs to consumers.[30] These programmers urge the Commission to provide increased incentives to cable operators to offer such packages of new programming services.[31] Other commenters suggested that a marketplace system is preferable to regulation in certain programming and tiering decisions.[32] In addition, as reflected in the record, many *ex parte* comments supported the adoption of rules allowing operators to establish tiers of new services priced at market rates.[33]

C. Discussion

22. We are concerned, based on the comments filed by operators and programmers, that our current rules may not provide sufficient incentives for operators to expand capacity and provide new services to consumers. Accordingly, we are establishing a new category of

CPSTs -- an NPT[6*] -- that will provide additional incentives for operators to provide new services to consumers because operators will be permitted to price these tiers as they choose. Our new rules also will help programmers by encouraging operators to add new attractive programming to NPTs in order to induce customers to subscribe to the NPTs.[7*]

23. Competition for NPTs. NPTs are, by definition, "cable programming services" under the 1992 Cable Act, because NPTs are composed of video programming provided over cable systems that are not carried on the BST and are offered in a package rather than exclusively on a per channel or per program basis.[34] We therefore have a duty under the 1992 Cable Act to ensure that NPTs are not unreasonably priced.[8*]

24. We find that, so long as the conditions set forth below are met, the rates for NPTs will not be unreasonable. The conditions set forth below will ensure that subscribers may choose to subscribe to BSTs, NPTs, or CPSTs or combinations of those tiers and, that as a result, NPTs will face competition from BSTs and CPSTs. We believe this for four reasons. First, all cable subscribers will continue to be able to purchase services on BSTs and CPSTs at reasonable rates set at either the benchmark or cost-of-service levels, with future rate increases limited by our rules. Second, the services provided on BSTs and CPSTs will be comparable to the services provided on NPTs, in that both types of tiers will provide programming packages that contain multiple channels of video programming services. Third, as explained below, operators offering NPTs will be required to preserve the fundamental nature of their BSTs and CPSTs as of September 30, 1994, so that cable operators that charge unreasonable rates for NPTs should attract few subscribers for their new offering. Fourth, because NPTs are likely to be composed primarily of channels not offered by the operator on September 30, 1994, operators will not have an established audience for NPTs when they are first introduced. Thus, market forces will ensure that operators will charge rates for NPTs that are low enough to attract new viewers.

25. Conditions for Offering NPTs. The principal reason for our belief that the rates charged for NPTs will not be unreasonable is that consumers retain the option to subscribe to BSTs and/or CPSTs regulated under the benchmark formula or pursuant to cost-of-service standards and therefore will not choose an NPT if the price is unreasonable. To ensure that BSTs and CPSTs continue to provide subscribers with a meaningful choice, our

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[6*] For purposes of the FCC Forms 1200 and 1210, channels that are on an operator's NPT will not be considered regulated channels.

[7*] Accordingly, we believe that this approach also will achieve the statutory goals of ensuring that "cable operators continue to expand . . . programs offered over their systems" and promoting "a diversity of views and information" by relying "on the marketplace, to the maximum extent feasible." 1992 Cable Act §§ 2(b)(1), (2).

[8*] We find that NPTs must be not unreasonably priced regardless of whether channels on NPTs are also offered on a per channel basis (*i.e.*, a la carte). *See* paras. 47,51, *infra*.

new rules establish the following conditions for operators offering NPTs.

26. First, operators offering NPTs are prohibited from making fundamental changes to what they offer on their BSTs and CPSTs on September 30, 1994.[9*] This requirement is necessary to ensure that cable subscribers continue to receive basically the same cable service they now receive at prices we have set pursuant to our rate regulations. This requirement, however, is not intended to freeze BSTs and CPSTs. Operators remain free to move channels from the existing tier to a single channel offering or drop channels entirely, so long as the aggregation of such changes does not constitute a fundamental change of their BSTs or CPSTs.

27. Second, operators may not drop channels from BSTs and CPSTs and move them to NPTs (including time-shifted, slightly altered or renamed versions of channels offered on other tiers), if the channels were offered on their BSTs or CPSTs on September 30, 1994. This will protect consumers by ensuring that operators electing to provide NPTs do not dilute the BSTs and CPSTs that are currently available to consumers. This will also help ensure that BSTs and CPSTs provide a competitive option to NPTs.

28. Third, BSTs and CPSTs must continue to be cognizable services. That is, the operator must continue to market its BSTs and CPSTs so that customers are reasonably aware of: (1) the availability of those tiers to the public; (2) the names of the channels available on those tiers; and (3) the price of the tiers. Within 30 days of the offering of an NPT, operators shall file with the Commission a copy of the new rate card that contains the following information on their BSTs, CPSTs, and NPTs: (1) the names of the programming services contained on each tier, and (2) the price of each tier. Operators also must file with the Commission copies of notifications that were sent to subscribers regarding the initial offering of NPTs. After this initial filing, cable operators must file updated rate cards and copies of customer notifications with the Commission within 30 days of rate or service changes affecting the NPT. This information will help the Commission ensure that operators are complying with our conditions for NPTs. No prior regulatory approval, however, is required to offer an NPT.

29. Furthermore, in accordance with the 1992 Cable Act's prohibition on negative option billing, an operator may not charge any subscriber for an NPT unless the subscriber has requested the NPT by name. Thus, a decision to subscribe to an NPT will be the product of affirmative consumer choice and reflect a decision to subscribe to the NPT in addition to, or in place of, other services. Moreover, fundamental changes to an NPT must be approved

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[9*] In our negative option billing regulation, we have provided that cable operators do not have to obtain the affirmative consent of subscribers before making changes "that do not result in the fundamental change in the nature of an existing service or tier of service." 47 C.F.R. § 76.981. We borrow from that regulation in concluding that cable operators offering NPTs must preserve the "fundamental nature" of their BSTs and CPSTs.

by subscribers in accordance with the negative option billing rules.[10*]

30. Operators may not require the subscription to any tier, other than a BST, as a condition for subscribing to an NPT. Further, operators may not require subscription to an NPT as a condition to subscribing to a CPST.[11*] We believe that restricting the ability of operators to link the purchase of NPTs and other CPSTs will maximize subscriber choice and foster competition between NPTs and CPSTs.

31. Apart from the foregoing limited, specific requirements, operators will have complete flexibility to offer programming services on an NPT. Thus, our NPT rules provide that operators may offer the same programming services on NPTs as are on one or more BSTs and CPSTs.[12*] This will permit operators to place high value channels on NPTs without constraining subscriber choice.[13*]

32. Operators may add any channel to an NPT that was previously on a BST or CPST if the channel was dropped from the BST or CPST before September 30, 1994. If a channel was offered on a system on a BST or CPST on September 30, 1994, however, the channel may not be moved to an NPT unless the operator waits at least two years from the date the channel is dropped from the BST or CPST. However, operators may offer new channels (i.e., channels first offered on a system after September 30, 1994) on CPSTs before moving them to NPTs, subject to the conditions outlined in this Report and Order. The

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[10*] We clarify below that channel changes involving relatively few channels generally will not change the fundamental nature of a tier and thus will not implicate the negative option billing rule. *See* para. 110, *infra*. Thus, the affirmative consent requirement will not unduly restrict operators' ability to tailor offerings on tiers to meet operator or consumer needs.

[11*] These restrictions will not apply to cable operators that, prior to October 5, 2002, lack the capacity to offer BSTs and NPTs without also providing other intermediate tiers of service (1) by controlling subscriber access to CPST channels of service through addressable equipment electronically controlled from a central point or through the installation, noninstallation, or (2) removal of frequency filters at the premises of subscribers without other alteration in system configuration or design and without causing degradation in the technical quality of service provided. *See* 47 C.F.R. § 76.921.

[12*] Cable operators may not state or imply that any such channel is available only on an NPT.

[13*] A channel that occupied a BST or a CPST part-time may be offered full-time on an NPT, as long as it continues to be offered on the BST or CPST under substantially the same conditions as it was offered on September 30, 1994. If a channel occupies a BST or CPST full-time, however, and is subsequently reduced to part-time on the BST and CPST, that channel may not be offered on an NPT full-time.

flexibility to move new channels to NPTs will keep the prices for CPSTs from becoming unreasonable and will create additional capacity for new services on CPSTs. This capacity should help create opportunities for programmers to establish an audience for their new channels.[14*]

33. These rules will be easy to apply. In order to offer an NPT, a cable operator is not required to complete any forms or obtain the approval of any agency. Furthermore, operators will be permitted to price NPTs as they choose and should encounter no regulatory problems unless they attempt to weaken their existing tiers of service so that BSTs and CPSTs do not compete effectively with NPTs. Although these rules will be clear and easy to apply, they also will ensure that subscribers will not be charged unreasonable rates. In short, our rules governing NPTs promote the goals of ensuring that the rates are reasonable and expanding opportunities for cable programmers to reach viewers.

34. Statutory Authority. The 1992 Cable Act directed the Commission to establish "criteria ... for identifying, in individual cases, rates for cable programming services that are unreasonable."[35] In addition, Congress instructed us, "[i]n establishing the criteria for determining in individual cases whether rates for cable programming services are unreasonable," to "consider" six factors.[36] Those six factors include: (1) the rates of similar cable systems; (2) the rates of systems that face effective competition; (3) the history of rates for a system; (4) the system's rates for the BST and equipment; (5) the system's capital and operating costs; and (6) the system's advertising revenues. We were not, however, instructed to consider each factor in the course of evaluating a particular system's rates, but instead were instructed to consider the factors in the course of establishing criteria by which to determine whether rates for CPSTs are unreasonable.

35. We considered the six statutory factors in the course of establishing our rate regulations, and our rate rules accordingly incorporate our analysis of those factors. In brief, the benchmark approach by which most cable operators set their rates is based directly on the first two factors -- the rates of similar systems and the rates of systems that face effective competition. The cost-of-service alternative is based directly on the last three factors -- the rates, costs, and revenues of a system. In addition, both approaches indirectly reflect our consideration of each factor, because the various factors are interrelated.

36. Our conclusion that the rates at which cable operators choose to offer NPTs will not be unreasonable reflects our consideration of the statutory factors that the Commission must consider in establishing criteria for determining whether a rate for a CPST is unreasonable. As explained above, we believe that the rates charged for NPTs will be

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[14*] If after initially electing to offer an NPT, a cable operator decides that offering an NPT is no longer desirable, the cable operator is free to drop the tier upon proper notice to subscribers. An operator that drops an NPT may reestablish that tier at a later time by complying with the conditions outlined above.

constrained by the rates charged for BSTs and CPSTs. Our rate standards for BSTs and CPSTs were set directly by our analysis of the factors the 1992 Cable Act instructs us to consider. We believe that the rates charged for NPTs must be competitive with the rates charged for CPSTs or consumers will decline to subscribe to NPTs. Therefore, the rates charged for NPTs will reflect our analysis of the statutory factors because cable operators will have to offer NPTs at prices that are attractive in comparison to services subject to our benchmark or cost-of-service regulations.

37. Our NPT rules depart to a degree from the "tier neutral" approach we have applied previously. Our benchmark and cost-of-service approaches to setting rates have required cable operators to set rates for BSTs and CPSTs under the same standard -- and thus are tier neutral -- while our approach to NPTs treats those tiers differently from other CPSTs. We find that this approach is consistent with our interpretation of the statute. We do not construe the statute to require tier neutrality, but to permit a tier neutral approach. For the reasons we have explained above -- primarily the desirability of providing incentives to cable operators to provide new outlets for programming -- we believe that a departure from tier neutrality is warranted for NPTs. Allowing cable operators to set the rates for NPTs, rather than requiring NPT rates to be set under the rules set forth in 47 C.F.R. § 76.922, is consistent with our statutory duties because NPTs will compete with tiers offered at rates regulated pursuant to our benchmark or cost of service rules. Accordingly, our treatment of NPTs will both promote the availability of additional channels to subscribers and ensure reasonable rates.

IV. A La Carte Package Offerings

A. Background

38. Under the 1992 Cable Act, video programming offered on a per channel or per program (a la carte) basis is not subject to rate regulation.[37] In the April 1993 *Rate Order*, we held that we would not regulate packages of otherwise exempt per channel or per program services so long as: (1) the price for the combined package does not exceed the sum of the individual charges for each component of service, and (2) the cable operator continues to provide the component parts of the package to subscribers separately.[38] We stated that the second condition would be met only when the per channel offering provides subscribers with a realistic service choice.[39] We also stated that we would retain jurisdiction to review packages of a la carte channels to determine whether the attempted offering constituted an evasion of rate regulation.[40]

39. Given the limited type of packages of per channel services that were available at the time we adopted the *Rate Order*, we believed that market forces would likely ensure that the rates for these offerings would be reasonable.[41] However, following the adoption of the *Rate Order*, a number of operators restructured service offerings so that channels that would have been subject to regulation were removed from a regulated tier and offered on both an a la carte basis as well as on a package basis. In our *Second Recon. Order*, we expressed

concern that the restructuring in some instances (1) may not be consistent with the purposes of the 1992 Cable Act, (2) may not comply with our requirement that subscribers must have a realistic option to purchase channels on an a la carte basis and (3) may constitute prohibited evasions of rate regulation.[42]

40. In the *Second Recon. Order*, we concluded that the public interest will be served by generally permitting nonregulated treatment of collective offerings of a la carte channels, if the offering enhances consumer choice and does not constitute an evasion of rate regulation. We concluded that these objectives would be achieved if operators complied with the standards set forth in our initial rules.[43] However, in order to address our concerns that some packages established by operators in response to rate regulation were not consistent with the 1992 Cable Act and our regulations, and the fact that other offerings raising similar concerns could be initiated in the future, the *Second Recon. Order* provided 15 interpretive guidelines for determining whether an operator's collective offering of a la carte channels should be accorded regulated or unregulated treatment. We stated that the guidelines would enable operators to better determine which packages of a la carte channels would be considered an evasion of rate regulation rather than a realistic service offering, and also would help local authorities and the Commission to assess expeditiously the appropriate regulatory status of specific packages of a la carte channels. We stated that in evaluating particular packages we would consider whether consumers were being offered a greater variety of programming options and whether the price for those choices was increasing or decreasing from previous levels.[44]

41. We also determined that packages of a la carte channels offered prior to April 1, 1993 (the date we adopted the *Rate Order*) would be accorded unregulated treatment. This limited "grandfathering" of packages available on April 1, 1993 was intended to avoid elimination of discounts that were available to consumers and clearly were not offered to evade rate regulation.[45] Finally, our *Second Recon. Order* stated that we would monitor our treatment of packages of a la carte channels and that, if it appeared that such offerings were not adequately fulfilling the purposes of the 1992 Cable Act, we would promptly revisit the issue.[46] Previously, on November 17, 1993, the Mass Media Bureau issued 16 letters of inquiry to various cable operators, and on December 13, 1993, it issued another 35 letters of inquiry, most of which addressed the issue of removal and repackaging of channels. On February 22, 1994, the Cable Services Bureau issued 11 letters of inquiry to cable operators that, among other things, asked operators to justify a la carte offerings that may be inconsistent with the Commission's rate regulations.

B. Comments

42. We have received numerous comments with respect to a la carte issues. Most of the commenters requested greater clarification of the Commission's a la carte rules and guidelines.[47] These comments indicate that our a la carte rules are thought to be very unclear and that clarification is needed before most operators are willing to market new a la carte offerings. Cable programmers suggest that the existing uncertainty makes it difficult for new

services to gain exposure to viewers either on regulated tiers or in a la carte packages.[48]

43. One major area of concern of commenters is the ambiguity surrounding the number of channels that can be moved from regulated tiers to an a la carte tier under our 15-factor test. For example, NCTA requests guidelines on what would constitute "significant" versus "insignificant" migration of channels from a regulated tier to an a la carte package under the test set forth in the *Second Recon. Order*.[49] Another issue that generated numerous comments involved clarification of the extent to which an a la carte package could be discounted as compared to the aggregate price of its components before we would conclude that the individual channels in an a la carte package were not "realistically" available to subscribers.[50]

44. Commenters also made suggestions concerning the treatment of a la carte offerings that are found not to meet Commission guidelines. Viacom suggests that the Commission adopt guidelines under which operators who have initially launched a service on an a la carte basis may safely move the network back to a regulated tier, so called "reverse migration."[51] Discovery Communications favors the adoption of guidelines that allow for the movement of a la carte channels back to regulated tiers without the requirement of affirmative consent under the negative option billing rule and without incurring liability of any kind.[52] These comments are premised on the theory that cable operators should not be penalized for failing to satisfy our test for a la carte packages because it is unclear.

C. Discussion

45. The evidence we obtained in response to the letters of inquiry issued to cable operators offering a la carte packages and the comments we have received from cable operators convince us that we should reconsider our approach. It seems clear that some cable operators have evaded rate regulation by purporting to offer channels a la carte, when in fact the individual offerings were not a realistic service alternative. On the other hand, we must acknowledge that there is merit to the industry's claim that neither our original two-part test nor our interpretative guidelines provides a clear answer with respect to the permissibility of some a la carte packages that have been offered. Indeed, it is perhaps inevitable that our test would not be capable of precise application in many instances because it is not clear how various factors should be weighed and applied.

46. Our analysis leads us to conclude, contrary to our prior decisions, that a la carte packages are CPSTs within the meaning of Section 3(l)(2) of the 1992 Cable Act. Justice Frankfurter said: "Wisdom too often never comes, and so one ought not to reject it because it comes late."[53] In this case, we think that the conclusion that all packages are "cable programming services" is supported by the language of the statute, the legislative history, and

practical considerations as well.[15*]

47. Section 3(l)(2) defines CPSTs as "any video programming provided over a cable system, regardless of service tier, including installation or rental of equipment used for the receipt of such video programming, other than (A) video programming carried on the basic service tier, and (B) video programming offered on a per channel or per program basis." A package of channels, whether or not the channels also are offered a la carte, plainly is "video programming provided over a cable system," and hence is a "cable programming service." The package is not "video programming offered on a per channel or per program basis;" the individual channels are. Accordingly, it is apparent from the statutory language that a la carte packages are cable programming services, and we therefore have a duty under Section 3(c)(1) to establish "criteria . . . for identifying, in individual cases, rates for cable programming services that are unreasonable." We acknowledged as much in our original decision authorizing a la carte packages when we said that, by authorizing a la carte packages, we were declining to "interpret[] the statute in . . . a literal fashion."[54]

48. A conclusion that rate regulation does not apply at all to video programming packages if the channels are offered individually would fatally undermine the rate regulation rules Congress enacted. If a package of a la carte channels is not a CPST, any cable operator may avoid rate regulation simply by announcing the offering of channels on an a la carte basis even if very few subscribers would choose the a la carte offerings rather than the package. For example, Adelphia Cable in Dade County, Florida purported to remove its entire 32-channel cable programming services tier (which had been priced at $13.95) from rate regulation by offering the individual channels a la carte. However, in order to receive a single channel a la carte, Adelphia imposed a $6 equipment charge plus a per-channel charge. Only two-tenths of one per cent of Adelphia's customers subscribed to individual channels rather than the package. Congress could not have intended to allow cable operators to evade rate regulation through such an offering. That practical consideration confirms our conclusion that a package of channels is a "cable programming service" whether or not the channels are offered a la carte.

49. The conclusion that a package of a la carte channels is a CPST is further supported by the legislative history, which focused on the fact that bundled offerings of cable programming would be subject to rate regulation. The Senate Report stated that the definition of "cable programming service" and the provision requiring the Commission to regulate the rates for such service "demonstrate the Committee's belief that greater unbundling of offerings leads to more subscriber choice and greater competition among program services. Through unbundling, subscribers have greater assurance that they are choosing only those program services they wish to see and are not paying for programs they do not desire."[55] While the Committee said it had "no desire to regulate programming," it nevertheless concluded that,

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[15*] To the extent commenters urge us to allow unregulated treatment of a la carte packages, we reject that approach as inconsistent with our statutory interpretation.

when bundling was involved, rate regulation of programming was necessary: "[B]ecause cable operators bundle transmission, equipment and programming, it is impossible to contain a cable operator's market power without oversight of the bundled rate. The Committee has tried to make this oversight minimal by . . . not extending regulation to programs offered on a per channel or per program (unbundled) basis."[56]

50. Similarly, the House Report indicated that "the only cable services potentially not subject to the Commission's regulatory authority would be services traditionally offered on a stand-alone, per-channel basis (premium channels like HBO or Showtime) or other programming that cable operators choose to offer on a per-programming service [sic], per-channel or pay-per-view basis."[57] In light of that legislative history, we think it clear that Congress intended all collective offerings of channels to be subject to our regulatory authority, as the statutory language provides.

51. However, as we recognized in the *Rate Order*, there are sound policy reasons to treat as reasonable any price offered for a package of channels that traditionally have been offered on a per-channel basis. Indeed, we cannot envision circumstances in which any price of a collective offering such as the commonly offered "HBO/Showtime" package would be found to be unreasonable. For the future, our new rules authorizing "new product tiers" should provide cable operators with sufficient flexibility to offer such packages at whatever price they choose. Although cable operators may not remove channels from regulated tiers and offer them on NPTs, they are free to create packages of a la carte channels under our new rules governing NPTs. Moreover, as stated above, we previously "grandfathered" packages available on April 1, 1993. The difficult question concerns the treatment of a la carte packages created between April 1, 1993, and September 30, 1994. In some cases we think it is clear that the package at issue was not a permissible package under a fair reading of our test.[58] In other cases, however, it is not clear how our test should be applied to the package at issue. In those cases, we think it is fair, in light of the uncertainty created by our test, to allow cable operators to treat existing packages as NPTs even though it would not qualify under the rules we establish today, provided that such packages involve only a small number of migrated channels.[16*] We see little reason to require an operator to "reverse migrate" a package that was not clearly ineligible for unregulated treatment under our a la carte policy. We intend to address whether specific operator packages should be treated as NPTs in ruling on individual cases in the near future.[59]

52. In sum, our experience with a la carte packages leads us to conclude that we should not have departed from a plain reading of the statutory text in the first place. The Supreme Court's recent decision in *MCI v. AT&T* confirms our conclusion that we should adhere to statutory language.[60] In that case the Court invalidated our "permissive detariffing" policy, pursuant to which we declined to require some telephone companies to file tariffs even

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[16*] As noted above, competition between an NPT and a BST and/or CPST is the primary reason that we conclude rates for NPTs will not be unreasonable. *See* paras. 23-25, *supra.*

though Section 203(a) of the Communications Act states that "[e]very common carrier ... shall designate, file with the Commission, and print and keep open for public inspection" tariffs showing its rates. Just as Congress directed us to require telephone companies to file tariffs, Congress has directed us to ensure that rates for packages of cable channels are not unreasonable.

53. Moreover, our experience with a la carte packages replicates the Supreme Court's experience in a different area. In *O'Callahan v. Parker*[61] the Court departed from "the plain language of Clause 14" of Section 8 of Article I of the Constitution[62] and held that a court-martial could try a defendant only if his offense was "service connected." In *Relford v. Commandant, U.S. Disciplinary Barracks*, the Court established a multi-factor test to determine whether an offense was "service connected."[63] Sixteen years later, the Court concluded that the multi-factor test "has proved confusing and difficult for military courts to apply."[64] The Court therefore overruled *O'Callahan*, abandoned the multi-factor test, and returned to a plain reading of Clause 14, explaining that "[w]hen considered together with the doubtful foundations of *O'Callahan*, the confusion wrought by the decision leads us to conclude that we should read Clause 14 in accord with the plain meaning of its language."[65] Although we have had only a few months' experience with our multi-factor test -- rather than the 16 years -- we have taken a similar course with respect to a la carte packages.

V. Adjustments to Capped Rates for Addition, Deletion and Substitution of Channels on CPSTs

A. Background

54. Pursuant to Section 623 of Communications Act[66] the Commission adopted a comprehensive framework governing the rates for BSTs and CPSTs. Under this framework, once initial rates are set pursuant either to the benchmark[17*] or cost-of-service[67] approaches set forth in our earlier orders, rates are governed by a price cap designed to assure that rates for regulated cable services remain reasonable.[68] Under the cap, operators may adjust rates annually for inflation as measured by the gross national product price index ("GNP-PI")[69] and for certain categories of external costs.[18*]

[17*] *See* 47 C.F.R. 76.922(b). The benchmark approach is designed to produce rates for regulated cable services that approximate the rates of cable systems subject to effective competition as defined in the 1992 Cable Act. *See generally, See Report and Order and Further Notice of Proposed Rulemaking ("Rate Order")*, MM Docket No. 92-266, 8 FCC Rcd 5631, 58 FR 29736 (1993) at paras. 14-15; *See Second Recon. Order* at paras. 67-105.

[18*] *See* 47 C.F.R. § 76.922(d)(3). These external costs include the additional or new retransmission consent fees incurred after October 6, 1994, other programming cost increases (with certain limitations for program purchases from affiliates), taxes, franchise fees, and the

55. Our price cap rules were amended in March, 1994 to specify a "going forward" mechanism under which capped rates are adjusted for changes in the number of channels offered on BSTs and CPSTs. Under these provisions, operators first remove all external costs from the tier charge and then adjust the residual component of the tier charge by a specified per channel adjustment amount when the total number of regulated channels changes.[19*] The methodology for adjusting capped rates when channels are added or deleted from a regulated tier is set forth in detail in section 76.922(e) of our rules and in FCC Form 1210.[70]

56. In March, 1994, we also permitted operators to include a mark-up of 7.5% on new programming expense related to programming added on or after May 15, 1994.[20*] In setting the 7.5% mark-up, we noted that virtually no one had provided any material evidence on what, if anything, would be an appropriate mark-up on new programming costs. We chose 7.5% as a "cautious choice" for an initial permitted mark-up on new programming expense and stated that we would monitor the impact of this permitted mark-up to assure its fairness to cable operators and subscribers.[71] We also issued a further notice of proposed rulemaking to determine if any changes in our going forward methodology were warranted to permit the

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costs of other franchise requirements including the costs of any public, educational, or governmental access obligations that a franchising authority requires the cable operator to provide and Commission regulatory fees. *Id.; See also Fourth Order on Reconsideration* ("*Fourth Recon. Order*"), MM Docket No. 92-266, FCC 94-40, 59 FR 18064 (1994) at paras. 11-14; 47 C.F.R. § 76.924(i).

Under our rules, an operator seeking to adjust capped rates to reflect changes in its external costs and inflation determines the actual level of its external costs. External costs are then removed from the total charge for the affected service tier, leaving a "residual." The "residual" is adjusted for inflation on an annual basis, but no earlier than September 30th of each year (when the final GNP-PI figure through June 30 of that year is released) and no later than August 31st of the following year. *See Second Recon. Order* at para. 174. Rates may be adjusted quarterly for net changes in external costs. *See First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking*, MM Docket No. 92-266, FCC 93-428, 9 FCC Rcd 1164 (1993) at para. 122.

[19*] *See Fourth Report* at paras. 247-48. The per channel adjustment amounts for systems with various numbers of channels appear as a table in our rules. *See* 47 C.F.R. § 76.922(e). The per channel adjustment declines from 52 cents for systems with seven or fewer regulated channels to ten cents with systems with 17 regulated channels to one cent for systems with more than 46 regulated channels. *Id.* The Technical Appendix to the *Fourth Report* describes how the per channel adjustment factors were calculated.

[20*] *See Fourth Report* at para. 246; 47 C.F.R. § 76.922(d)(3)(xi). Form 1210 allows the 7.5% mark-up on all programming cost increases occurring after March 31, 1994, no matter when the channel was first offered.

continued growth of programming services.[72]

B. Comments

57. Parties filing petitions for reconsideration and many commenters filing in response to the *Fifth Notice* ask the Commission to revise the existing going forward rules substantially.[73] Many criticize the existing per channel adjustment. Some argue that the current methodology for calculating per channel adjustments is flawed because it is based on the rates charged by systems of various sizes, rather than the costs or rate effects of adding a channel.[74] Operators also argue that the existing mechanism fails to provide sufficient incentives to add channels.[75] Others allege that the per channel adjustments are not sufficient to cover the costs of rebuilding systems.[76] Some programmers and networks also contend that the declining per channel adjustment methodology is inadequate.[77] USA Network proposes a per channel adjustment of no less than five cents per channel for each new channel added to a system, which, it says represents the cost to a 26-channel system of activating one channel.[78]

58. The Consumer Federation of America ("CFA") argues that our existing going forward rules provide operators with sufficient incentives to add new channels. CFA states that cable operators threaten to close off new and existing outlets for programming under existing rules in an attempt to use programmers as a means of putting pressure on the Commission to increase the rates cable operators may charge for channel additions.[79]

59. Most petitioners and commenters contend that the current 7.5% mark-up on new programming is an inadequate incentive for operators to add new programming services to regulated tiers.[80] Cable operators, programmers, and networks state that the percentage-based approach to the programming mark-up results in disincentives for operators to add low- or no-cost services to BSTs and CPSTs (noting that 7.5% of zero is zero).[81] The commenters state that the percentage-based approach is particularly problematic for new services because they generally are offered, at least initially, as low-cost or no-cost services. Similarly, long-term carriage of services having business plans that make them low- or no-cost is less attractive.[82] Some suggest that the percentage mark-up approach gives operators an incentive to replace low cost services with higher cost services and, accordingly, also encourages programmers to raise their licensing fees.[83] Public Interest Petitioners and others allege that because programming targeted to specific groups, such as minorities, is generally low- or no-cost programming, these groups are disproportionately harmed by the percentage mark-up methodology.[84] Others more generally state that the 7.5% mark-up fails to provide sufficient incentives.[85] They suggest that the 7.5% mark-up does not account for the costs of launching a new channel, including the foregone opportunity to devote the new channel to unregulated services.[86] Some argue that the current mark-up deters investment and stifles innovation in the industry.[87] Others suggest that the existing rules may cause operators to add no, or at most only a few new channels.[88] Some programmers, however, favor retention of the 7.5% markup.[89]

60. Most of the alternatives on going forward issues proposed by the industry involve a flat per channel charge. The National Cable Television Association ("NCTA") and Telecommunications, Inc. ("TCI") submitted economic studies to support a flat per channel adjustment of at least 25 to 30 cents.[90] Others propose a flat fee for new services and a percentage mark-up on increased costs for existing services,[91] or a flat fee adjusted for inflation.[92] Continental Cablevision, Inc. ("Continental") proposed setting the mark-up on new channels at a rate equal to the average mark-up that an operator was allowed per channel on existing regulated services.[93]

61. Some, including NCTA, propose a flat-fee mark-up subject to an annual cap. Cablevision Industries, Inc. ("CVI") supports a flat fee mark-up of 35 to 40 cents per channel, plus licensing fees with a $1.50 annual cap on the aggregate rate increases attributable to the per channel mark-up and license fees.[94] CVI adds that the cable operator, rather than the programmer, should be allowed to retain the vast majority of the rate increase associated with the addition of a new channel.[95] CVI argues that an annual cap encourages operators to choose new services wisely while minimizing the risk of adding services merely to justify higher rates.[96] CVI also would allow operators to accrue such increases for two years to accommodate upgrades and rebuilds.[97] The Cable Telecommunications Association ("CATA") agrees with the flat fee with an annual cap approach and suggests a mark-up of between 25 and 50 cents with a cap of an unspecified amount.[98] Others propose an annual cap applicable only to the mark-up and not the underlying license fee.[99] Others disagree with the adoption of an annual cap,[100] arguing that an annual cap discriminates against high cost services and thus, at a minimum, a cap should not be applicable to services such as regional news and sports.[101] The Commission also received comments suggesting that it should adopt separate going forward rules specifically applicable to small systems.[102]

62. In addition to the comments in this proceeding, in response to, and during the period contemplated by, the *Fifth Notice*, the Commission has received a number of other informal comments from representatives of operators, programmers, local franchising authorities and public interest groups discussing proposed revisions to the going forward rules. NATOA also argued against permitting programming additions to BSTs on the ground that to do so would force BST-only subscribers -- "who include many low-income and elderly subscribers and captive subscribers who could not otherwise receive over-the-air broadcast stations" -- to pay for programming they did not want.[103] NATOA urged the Commission to limit the ability of operators to take advantage of new permitted rate increases to add home-shopping revenues, advertising revenues and other compensation from certain programming services.[104] NATOA also expressed concern over license fee increases in years subsequent to those covered by any license fee cap, suggesting either limiting license fee increases to inflationary adjustments, requiring that new services be moved to a new tier or offered only a la carte at the end of the capped period or eliminating the rate increase made on the channel's addition.[105] Finally, NATOA urged the Commission not to permit channel additions to the BST so as to minimize the regulatory burden on local franchising authorities.[106]

63. The City of St. Louis, Missouri, argues that revisions to the current going forward rules will cause rate shock to consumers. They questioned whether operators need additional incentives above benchmark rates to add new channels and expressed concern over a perceived lack of protection against more shopping and advertising channels and double-recoveries by operators through revenues from programmers.[107] The Consumer Federation of America also expressed concern that a flat mark-up would encourage the addition of home shopping and low cost programming.[108] The St. Louis letter supports NATOA's arguments against encouraging channel additions to BSTs. The letter urges the extension of price caps in respect of programming costs for as long as a channel is on a BST/CPST or, in the alternative, that the new rules require the channel's removal on termination of the price cap restraints. Finally, the St. Louis Letter states the Commission should seek to ensure that the financial gain from additional channels goes to programmers rather than operators.[109]

C. Discussion

64. As noted, the Commission previously adopted a mechanism by which cable operators may adjust rates when adding channels to BSTs and CPSTs.[110] The Commission is supplementing its existing going forward rules by creating an alternative channel adjustment methodology. Cable operators adding channels to CPSTs under the new, supplemental rules may receive (1) a flat per channel mark-up, subject to a cap through December 31, 1997, and (2) recovery of programming costs, subject to a cap through December 31, 1996, and pursuant to our existing rules on permitted programming costs through December 31, 1997, modified to remove the 7.5% mark-up. In so doing, the Commission seeks to permit operators to provide new services on CPSTs, while assuring that rates for CPSTs are not unreasonable.[111] Our new rules will benefit consumers by assuring that operators will have incentives to add new services, but without the unreasonable rate increases that some operators implemented prior to regulation. Our revised going forward rules will form an integral part of our comprehensive regulatory framework governing cable service rates.

65. Operators may adjust rates for CPSTs pursuant to our new going forward rules beginning January 1, 1995, the effective date of the new rules, for channel changes, if any, made to these tiers on or after May 15, 1994, the effective date of our existing going forward rules. Operators adding channels to CPSTs on and after May 15, 1994, may use either the new rules or the existing rules for adjusting rates. Thus, under the regulatory requirements we establish today, the permitted charge for a CPST will consist of two elements. The first element is the permitted rate for channels offered on CPSTs on May 14, 1994, determined under current rules. The second element is the permitted rates for channels added to, or dropped from, CPSTs on or after May 15, 1994, determined under our new rules, or, if the operator so elects with respect to channel additions, our current rules as modified to remove the 7.5% mark-up on increases in programming costs under certain circumstances described below.[112] Operators must elect to apply either our new rules or our current rules the first time they adjust rates after December 31, 1994, to reflect a channel addition to a CPST that occurred on or after May 15, 1994, and must use the elected methodology for all rate

adjustments through December 31, 1997.[21*] Rates for the BST will continue to be governed exclusively by our current rules, except that where a system offered only one tier on May 14, 1994, the cable operator will be allowed to use the revised rules for channel additions to the BST, as if the tier was a CPST.

1. "Going Forward" Price Cap Structure

66. Operators electing to use the new rules may adjust their rates between January 1, 1995 and December 31, 1997, by up to 20 cents, exclusive of license fees, for each new channel added to CPSTs on or after May 15, 1994, subject to the Operator's Cap and the reserve for license fees, described below. Operators are not required to raise rates, but rather are permitted to do so. Operators may add channels under the new rules at any time from May 15, 1994 to December 31, 1997. They may not, however, raise their prices as a result of channel additions by more than $1.20 per subscriber per month between January 1, 1995, and December 31, 1996, and by more than $1.40 between January 1, 1995, and December 31, 1997 ("Operator's Cap").

67. Operators may use any portion of the Operator's Cap to pay for license fees between January 1, 1995 and December 31, 1996 for channels added between May 15, 1994 and December 31, 1996. Moreover, operators may recover an additional amount of not more than 30 cents per subscriber per month for license fees (the "License Fee Reserve") between January 1, 1995 and December 31, 1996 for channels added between May 15, 1994 and December 31, 1996.[22*] After December 31, 1996, license fees may be passed through to subscribers pursuant to our existing rules, except that, as described below, operators will not be allowed the current 7.5% mark-up on programming costs for channels added on or after May 15, 1994.[113]

68. The new going-forward rules for channel additions should benefit consumers by increasing their viewing options on existing CPSTs, while avoiding unreasonable price

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[21*] While we are requiring that operators use either the existing or the new going forward rules consistently for channel additions to CPSTs after December 31, 1994, an operator that chooses to use the new rules after that date may, but is not required to, adjust rates to reflect the new rules for channel additions made between May 15, 1994 and December 31, 1994. We are allowing operators to choose to continue using the current rules because the current rules provide greater channel addition incentives than the new rules in certain limited circumstances and some operators may have relied on the current rules in deciding to add channels.

[22*] The Operator's Cap and License Fee Reserve only apply to costs associated with new channels on CPSTs and do not affect the ability of operators to obtain rate adjustments for inflation or changes in external costs other than increases in programming costs of channels added under the new going forward rules. See 47 C.F.R. §§ 76.922(d)(2), (3).

increases for those tiers. Our revised rules are designed to continue to give "primary weight to the rates of systems subject to effective competition" in determining whether CPST rates are unreasonable.[114] As we explain in the Technical Appendix (attached as Appendix C to this Report and Order) the particular channel adjustment factors that we incorporate into our rules are based on a comprehensive analysis of the changes in channel offerings and rates operators made during the years prior to regulation, adjusted to account for the lack of effective competition. Just as cable systems that are subject to effective competition continue to add channels to CPSTs, our new rule is designed to allow some additions to these tiers by systems subject to regulation. We will permit such channel additions to be reflected in reasonable price increases commensurate with the added value subscribers are receiving.

69. A Commission review of a sample of 500 systems reported in the *Television and Cable Factbook* indicates that, in the five years prior to the passage of the 1992 Cable Act, 18.2% to 31.5% of cable systems in any one year increased rates by more than $0.50 per channel added, 3.3% to 10.8% raised rates by $1.50 or more per channel added and some raised rates by as much as $8.00 per channel added. The average per channel price for channels currently offered on BSTs and CPSTs is 43 cents and for channels currently offered on CPSTs is 65 cents.[23*] The $1.50 cap on retail price (i.e., the $1.20 Operator's Cap over two years plus the 30 cent License Fee Reserve) increases resulting from channel additions to CPSTs will allow subscribers to CPSTs to receive as many as six additional channels at an average cost of 25 cents per channel, including license fees, during the first two years.[24*] Our observation that six channels could be added at 25 cents per channel is not intended to limit the number of channels an operator may add to its CPSTs under our revised rules during the first two years. All that our rules require is that rate increases be limited. An operator is free to add as many channels as it wishes so long as it limits its rate increases.

70. The Commission recognizes that allowing operators to use the new rules when they add channels to CPSTs, but not when they add channels to BSTs, may create greater incentives to add channels to CPSTs than to BSTs. We believe this departure from tier neutrality is justified for at least three reasons. First, we agree with NATOA that preserving

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[23*] The figure for BSTs and CPSTs is an average for a random sample of 500 cable systems taken from the *Television and Cable Factbook* for the year 1991, the last year included in the sample. The figure for CPSTs is based on the 51 systems in the random sample of 500 systems offering CPSTs in each year from 1986 to 1991. Adjusting the 1991 prices for inflation would yield a 48 cents average price per channel for BSTs and CPSTs and 69 cents average for CPSTs in 1994 dollars. *See Television and Cable Factbook*, Volumes 54-59 (Warren Publishing 1986-1991).

[24*] As explained in the Technical Appendix, the $1.50 cap is the result of a 20 cent per channel mark-up and an average 5 cent per channel license fee, multiplied by 6 channels. An additional rate increase up to 20 cents plus license fee may be taken in the third year, if an additional channel is added (a seventh channel),